Good Practice Note

Judgements and Estimates

Enhancing the quality of local government annual accounts

AUDIT SCOTLAND

Prepared for local government bodies and appointed auditors

5 March 2021

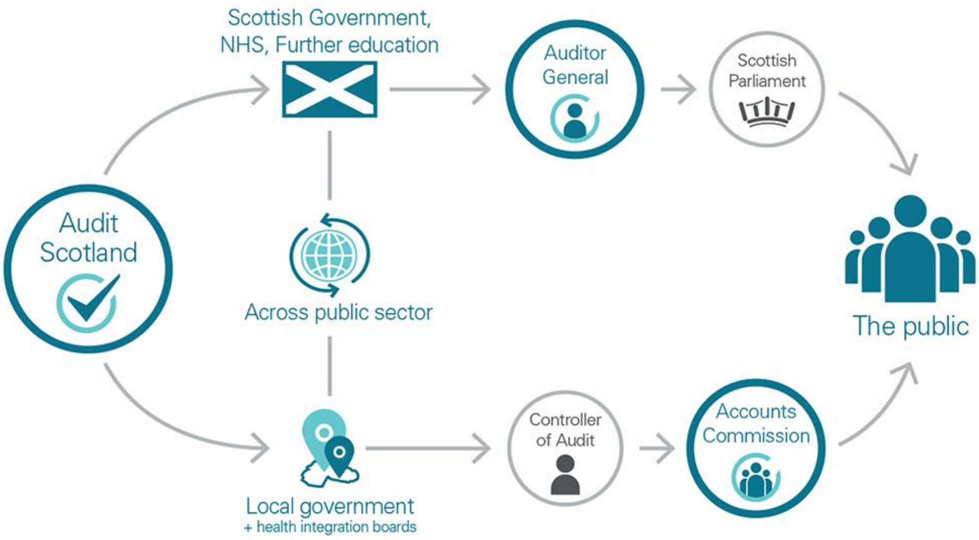
Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- The Auditor General is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.

- The Accounts Commission is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.

- Audit Scotland is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.



About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money

- reporting our findings and conclusions in public

- identifying risks, making clear and relevant recommendations.

Contents

Introduction

Purpose

1. Audit Scotland promotes high quality financial reporting in Scottish public bodies. Audit Scotland's Professional Support carries out reviews of annual accounts to identify and share examples of good practice reporting and highlight areas where enhancements can be made.

2. This Good Practice Note shares the findings from a review of the significant accounting judgements and sources of estimation uncertainty disclosed within the 2019/20 financial statements of the 30 Scottish councils available at the time of the review. It is intended to act as a catalyst for councils to assess and enhance their own disclosures going forward.

Councils should use this Good Practice Note to assess and enhance their own disclosures

Context

3. The disclosures of accounting judgements and estimation uncertainty were chosen for a good practice review because of their fundamental importance in understanding the financial statements, along with indications that the quality of the disclosures was variable. This variability was particularly highlighted in 2019/20 in respect of disclosures in cases where a 'material valuation uncertainty' had been declared in a valuer's report.

4. The good practice review was carried out by a team in Professional Support with knowledge of the relevant financial reporting framework. However, the team does not have a detailed understanding of each council's particular circumstances or the specific underlying transactions.

The examples in this note are presented unaltered from councils' 2019/20 financial statements

Disclosure requirements

5. The Code of Practice on Local Authority Accounting in the UK adopts the requirements in IAS 1 Presentation of Financial Statements to disclose significant accounting judgements and sources of estimation uncertainty. The judgements and estimates referred to affect current and future financial statements differently. This is reflected in the different disclosure requirements:

- Paragraph 3.4.2.89 of the accounting code requires disclosure of judgements made by management in applying the council's accounting policies, but this explicitly does not apply to those relating to estimates.
- Paragraph 3.4.2.91 of the accounting code requires more wide-ranging disclosure of management assumptions about the future and other of sources of estimation uncertainty.

6. To make this distinction clear in this Good Practice Note, disclosures in the scope of paragraphs 3.4.2.89 and 3.4.2.91 are described as 'judgements' and 'estimates', respectively.

Judgements

7. The disclosure requirements of paragraph 3.4.2.89 are limited to the judgements a council's management makes when applying its accounting policies that have the most significant effect on carrying amounts in the financial statements. The disclosure should be of sufficient detail to help users understand how policies have been applied and to enable them to compare judgements between different councils' financial statements. Examples of such judgements include whether:

Judgements relate to applying accounting policies

- a lease should be classified as operating or finance, or an arrangement contains a lease
- a Public Private Partnership (PPP) contract is a service concession arrangement

- the council controls or significantly influences another entity
- the council is acting as principal or agent in a particular transaction
- a liability should be recognised as a provision or disclosed as a contingent liability.

Estimates

8. The disclosure requirements for paragraph 3.4.2.91 relate to assumptions and estimates at 31 March that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. All three factors apply (i.e. risk, materiality and timescale), which limits the number of items that require to be disclosed.
9. Paragraph 127 of IAS 1 states that the requirements relate only to the most difficult, subjective and complex judgements. Disclosure is not required for assets and liabilities measured at fair value if this is based on quoted prices in an active market for an identical asset or liability. Examples of estimates include:

- the depreciated replacement cost of specialised assets
- selection of discount rate for pensions
- provisions subject to the future outcome of litigation in progress at the year end
- determination of asset useful lives for depreciation
- collection rates for debtors.

10. Details are required of the relevant assets and liabilities and their year end carrying amounts. Paragraph 129 of IAS 1 gives examples of disclosure that may help users understand management's judgements about the future:

- the nature of the assumption or other estimation uncertainty
- the sensitivity of the assets and liabilities to the assumptions, including the reasons for the sensitivity
- the expected resolution of the uncertainty and the range of reasonably possible outcomes within the next financial year
- an explanation of any changes made to past assumptions, if the uncertainty remains unresolved.

11. They are not all required to be disclosed but, in most cases, some additional disclosures are necessary in order to fully understand the estimates made. This should provide users with sufficient detail that they can share in management's understanding of the uncertainties underlying those estimates.

Contact points

12. The contact points in Professional Support for this Good Practice Note are:

- Paul O'Brien, Senior Manager – pobrien@audit-scotland.gov.uk
- Neil Cameron, Manager – ncameron@audit-scotland.gov.uk.

Key messages

1 **Judgements and estimates should be separately identified and the relevant disclosures provided for each:**

- **Make sure judgements are distinguished from estimates and disclosed in the appropriate note accordingly**
- **Do not include risks that are neither judgements nor estimates**
- **Consider positioning the judgement note immediately before the estimates note, following on from the accounting policies**
- **Explain the distinction between judgements and estimates.**

2 **Detailed descriptions should be disclosed of the specific, significant judgements made by the council in applying the accounting policies:**

- **Only disclose those judgements that have a significant effect on the financial statements**
- **Avoid an over-reliance on illustrative disclosure notes in the accounting code guidance notes**
- **Provide sufficient details to help users understand how the policy has been applied, the areas of subjectivity and the basis for the council's judgement**
- **Provide the background to the judgement, the technical reference and the basis for the conclusion**
- **Provide information to allow the impact of alternative judgements to be assessed.**

3 **Disclosures related to estimates should focus on those with a significant risk of a material adjustment to the carrying amount of assets and liabilities within the next year:**

- **Only disclose estimates where the adjustment to carrying amounts is expected to be material**
- **Explain why the risk of adjustment was considered to be significant**
- **Explain the future event that will reduce or remove the uncertainty**
- **Differentiate longer term risks of adjustment from those relating to the following year**
- **Consider whether sources of uncertainty in previous years remain relevant.**

4 **Disclosures to be clear and specific, pinpointing the precise sources of uncertainty and avoiding the use of boilerplate language:**

- **Avoid an over-reliance on the illustrations in the accounting code guidance notes**
- **Explain the sources of uncertainty rather than simply describe process**
- **Be clear and explain why the areas of estimation uncertainty disclosed were considered to be significantly difficult, subjective or complex**
- **Consider the appropriate use of cross referencing.**

5 **The specific amounts at risk of material adjustment should be disclosed, rather than just the value of the financial statement line item within which these are contained:**

- **Disclose the specific amounts at risk of material misstatement**
- **Consider the appropriate level of disaggregation.**

6 **The assumptions underlying estimates should be quantified when users need this information to fully understand their effect:**

- **Quantify assumptions so users can understand the positions taken**
- **Provide clear reasons for choosing the numerical assumptions made.**

7 **The sensitivity of carrying amounts to assumptions and estimates, and/or the range of reasonably possible outcomes within the next financial year should be disclosed:**

- **Explain the sensitivity of carrying amounts to changes in assumptions**
- **Disclose the range of possible outcomes**
- **Set out how the uncertainty is expected to be resolved**
- **Explain where the council's view sits within a range of outcomes**
- **Where it is impracticable to explain the extent of possible effect, disclose that fact and state that it is reasonably possible that a change in assumptions could require material adjustment.**

8 **Changes to past assumptions should be explained where the uncertainty remains unresolved:**

- **Provide required disclosures on changes to past assumptions.**

9 **The declaration of a 'material valuation uncertainty' should be clearly disclosed in the estimates note:**

- **Disclose a 'material valuation uncertainty' in the estimates note**
- **Provide a clear explanation of the impact.**

Section 1

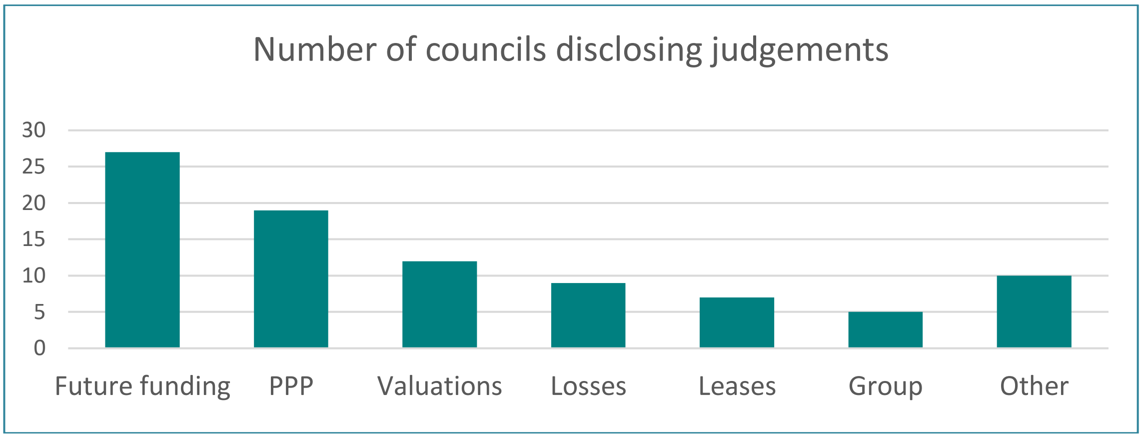
Differentiation between judgements and estimates

Judgements and estimates should be separately identified and the relevant disclosures provided for each

13. All councils reviewed distinguished judgements from estimates by including disclosures in separate notes to the financial statements. The better disclosures located the two notes together immediately after the accounting policies, with judgements preceding estimates.

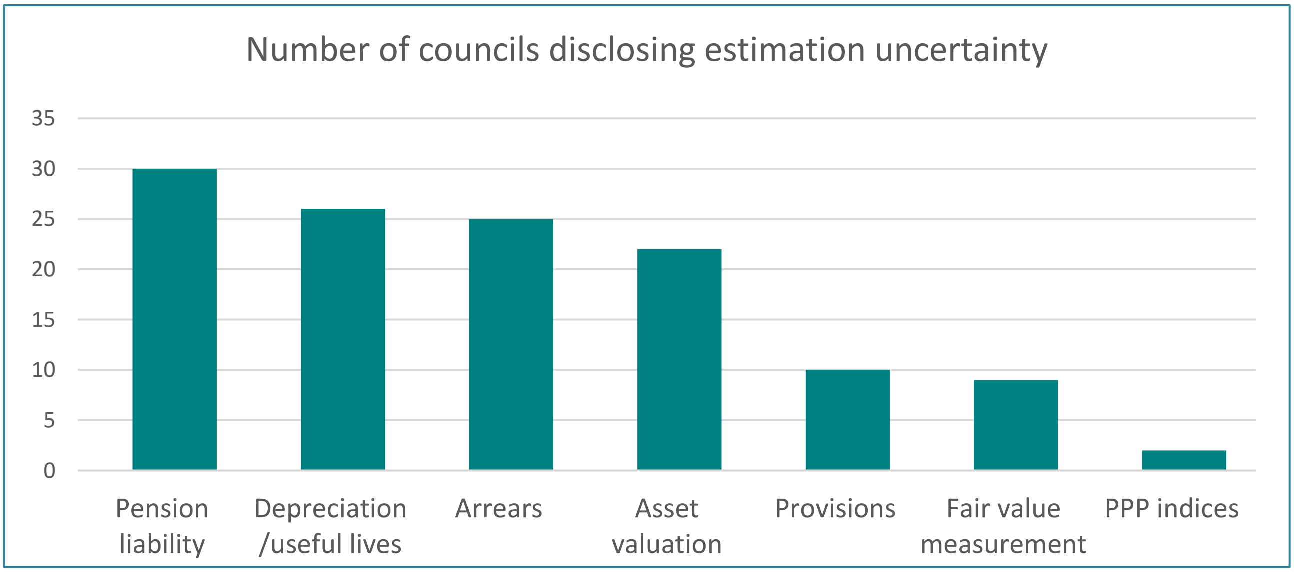
14. The number of judgements disclosed ranged from one to six, with an average of three. The most commonly disclosed judgements are set out in Exhibit 1:

Exhibit 1



15. The most commonly disclosed estimates are set out in Exhibit 2:

Exhibit 2



16. The number of estimates disclosed by each council ranged from one to seven, with an average of four. Appendix 3 considers the impairment of arrears as a brief case study.

17. 15 councils disclosed a 'material valuation uncertainty' declared by the valuer in the estimates note (and a further 6 councils disclosed it elsewhere). As this is an unusual item that is expected to recur in 2020/21, this disclosure is examined in Section 9.

18. Around a half of councils misclassified estimates and disclosed them as judgements. These related to:

- holiday pay accrual (included in 'other' in Exhibit 1)
- 'material valuation uncertainty'
- valuation of investments.

19. The 'other' category in Exhibit 1 also includes items that were not actually judgements or estimates at all (e.g. general risks around EU withdrawal) which would have more helpfully been placed in the Management Commentary.

20. It would be helpful to users if councils explained that the judgements note dealt with the application of accounting policies while the estimates note dealt with estimation techniques. A few councils explained the distinction to some extent (see Exhibit 3 for examples) but could helpfully have gone further:

Exhibit 3

6. Critical judgements in applying accounting policies

In applying the accounting policies set out in Note 5, the Council has had to make certain judgements about complex transactions or those involving uncertainty about future events (see Note 7). The critical judgements made in the Annual Accounts are:

Note 34 – Assumptions Made about the Future and Other Major Sources of Estimation Uncertainty

The disclosure requirements for sources of estimation uncertainty apply to a limited set of matters. They relate to assumptions and estimates at the end of the current reporting period that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. All three factors apply in applying the assumptions made around the key areas of estimation uncertainty.

Areas for improvement:

Make sure judgements are distinguished from estimates and disclosed in the appropriate note accordingly

Do not include risks that are neither judgements nor estimates

Good practice

Consider positioning the judgement note immediately before the estimates note, following on from the accounting policies

Explain the distinction between judgements and estimates

Section 2

Specific and significant judgements

Detailed descriptions should be disclosed of the specific, significant judgements made by the council in applying the accounting policies

21. It was not always clear why the disclosed judgements were considered to have a significant effect on the financial statements. The disclosure of insignificant matters obscures the judgements that do have the most significant effect.

22. There appears to be an over-reliance on the illustrative disclosure notes provided in the accounting code guidance notes leading to boiler-plate language and uniform selection of judgements to disclose. Most councils tended to include only those judgements illustrated in the guidance notes. For example, 27 councils referred to uncertainty in local government funding and all concluded that impairment of assets was not appropriate. In general, the disclosures closely followed the illustrative wording with most councils using narrative similar to that set out at Exhibit 4:

Exhibit 4

Future Grant Funding
There is a high degree of uncertainty about future levels of funding for local government. However, the Council has determined that this uncertainty is not yet sufficient to provide an indication that the assets of the Council might be impaired as a result of a need to close facilities and to reduce levels of service provision.

23. As with all boiler-plate text, the disclosures in most cases could apply to any local authority and gave no additional useful information to users. Where councils use the guidance note wording as the basis for their disclosure, they should treat it only as a starting point to build on so the information actually disclosed is specific to the council's circumstances. For example, some councils, linked the disclosure on future funding to savings plans or financial strategy. Councils should also consider which judgements other than those illustrated are relevant to their own financial statements.

24. Councils did not always provide sufficient detail to help users understand how they had formed their judgements or provide justification for the view taken. The better disclosures explained the basis of the judgements made, the key factors taken into account, and why the council believe the judgement is appropriate. The disclosure should also highlight those areas where others could reasonably reach a different judgement.

25. Councils generally referred to particular items in the financial statements but often did not give details of the areas of subjectivity or the basis for management's judgement. Examples of unhelpful disclosure included:

- the classification of potential losses as contingent liabilities or provisions, without identifying the specific losses where judgement was complex or the factors affecting the judgement

- disclosing lease classification as a key judgement without indicating for which leases this was particularly difficult, or the cause of the complexity.

26. The examples in Exhibit 5 provide the background to the judgement, the technical reference and the basis for the conclusion. The first example identifies the standard the judgement was based on, while the second includes specifics about the assets covered and their carrying value:

Exhibit 5

The Council has entered into a Public Private Partnership (PPP) for the provision of educational buildings, their maintenance and related facilities. The Council has considered the tests under IFRIC12 and concluded this is a service concession.

5.1 Provision of School Buildings and Waste Facility

The Council is deemed to control the services provided under the Public Private Partnership agreements (PPP1 and PPP2) and the Design, Build, Finance and Maintain (DBFM) for James Gillespie's High School, for the provision of school buildings, maintenance and other facilities with Edinburgh Schools Partnership (PPP1), Axiom Education Limited (PPP2) and Hub South East Scotland (JGHS). The Council has entered into an agreement for the provision of the new Queensferry High School which is currently under construction under a DBFM arrangement.

The Council is deemed to control 80% of the services provided under the DBFM for Millerhill Residual Waste Facility (20% controlled by Midlothian Council).

The accounting policies for public private partnerships have been applied to these arrangements and the schools and waste facility (valued at net book value of £519.948m and £100.955m respectively at 31 March 2020) are recognised as Property, Plant and Equipment on the Council's Balance Sheet.

27. Appendix 1 provides tips to assist councils in selecting appropriate items for disclosure in the judgements note and in making sure the appropriate information is provided.

Appendix 1 provides tips on disclosing judgements

Areas for improvement

Only disclose those judgements that have a significant effect on the financial statements

Avoid an over-reliance on illustrative disclosure notes in the accounting code guidance notes

Provide sufficient details to help users understand how the policy has been applied, the areas of subjectivity and the basis for the council's judgement

Good practice:

Provide the background to the judgement, the technical reference and the basis for the conclusion

Provide information to allow the impact of alternative judgements to be assessed

Section 3

Estimates with risk of material adjustment

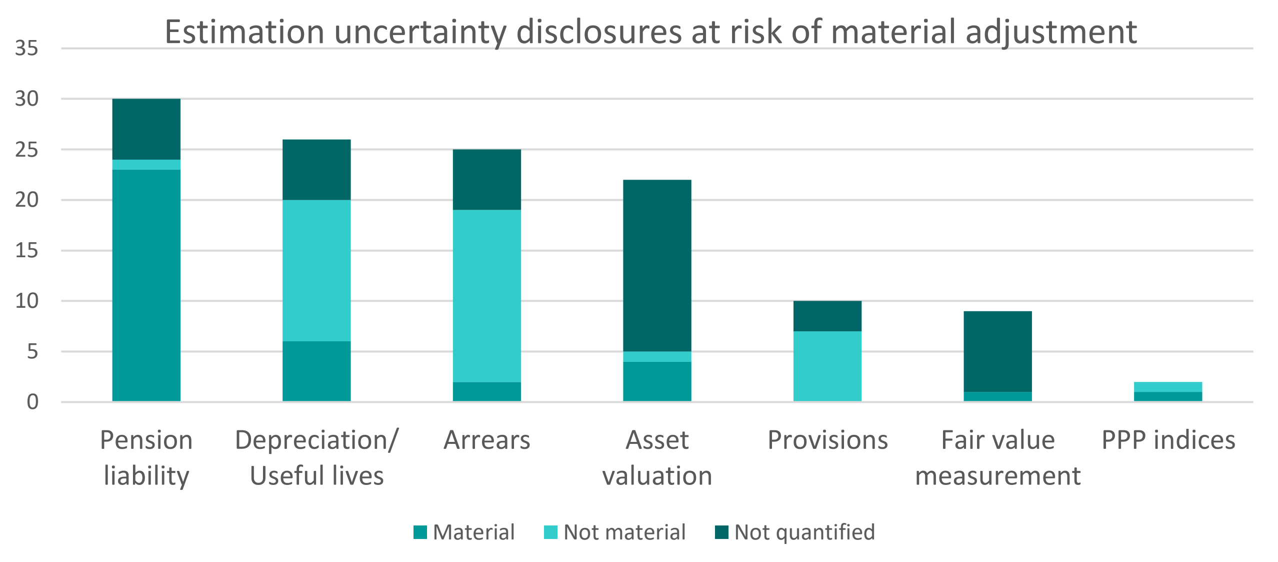
Disclosures related to estimates should focus on those with a significant risk of a material adjustment to the carrying amount of assets and liabilities within the next year

28. Estimation uncertainty disclosures deal with situations where a council has incomplete or imperfect information which will only be enhanced as a result of future events. The disclosure requirement focusses on assets and liabilities whose carrying amount relies on estimates for which there is a significant risk that re-estimation with material effect during the next 12 months may be required.

29. 25 councils disclosed estimates where, although they may have related to material carrying amounts, it did not appear that they would result in an adjustment that was material.

30. Exhibit 6 provides a summary of the extent to which disclosures related to adjustments that did not appear to be material (or were not quantified). In order to provide an indication of materiality, Professional Support compared the value of the adjustment disclosed with the materiality level set by auditors for their audit of the relevant council's financial statements:

Exhibit 6



31. The 30 councils reviewed disclosed a total of 137 estimation uncertainty items. Of these disclosures, 40 items appeared to relate to material adjustments, while for the other 97 the adjustments appeared to be below the materiality set by the auditor or had not been quantified. Exhibit 7 provides an example of a council setting out the amounts involved:

Less than one third of disclosed adjustments appeared material

Exhibit 7

Effect if Actual Results Differ from Assumptions

The net book value of all council property, plant and equipment subject to revaluation through the 5 year revaluation cycle is £728.728 million. Assets revalued in 2019/20 totalled £191.995 million before revaluation. The impact of a 5% change in valuation of these would be £12.620 million, either resulting in an increase or decrease in the Council's revaluation reserve or an additional impairment charge. There would be no impact on the Council's general fund.

If the useful life of the asset is reduced, depreciation increases and the carrying amount of the asset falls. It is estimated that the annual depreciation charge would increase by £5.034m for every year that useful lives had to be reduced.

32. The elements that the disclosure is required to focus on are summarised in the following table along with findings from the review:

Disclosure focus	Review findings
Estimates where the risk of adjustment is significant	Disclosures did not generally explain why the risk of adjustment was considered to be significant as opposed to the routine risk attached to any estimate
Adjustments due to re-estimation within the next 12 months	Some councils disclosed estimates where the adjustment would arise in a period longer than 12 months; for example, disclosures in respect of provisions for asset decommissioning and pensions. While it may be helpful to provide disclosures on such longer-term estimates, the disclosures should be clearly differentiated from those relating to the following year
Situations where there is incomplete or imperfect information which will only be enhanced as a result of future events	Disclosures did not generally explain the future event that would reduce or remove the uncertainty. In some cases, councils disclosed possible future changes in market values but these have no impact on the carrying amount at the year end and should therefore not be disclosed

33. Sources of estimation uncertainty may vary from year to year. Councils are expected to reassess whether disclosures made in a previous year remain relevant, to avoid accumulating clutter. There was little indication that such an assessment had taken place in 2019/20.

Areas for improvement

Only disclose estimates where the adjustment to carrying amounts is expected to be material

Explain why the risk of adjustment was considered to be significant

Good practice:

Explain the future event that will reduce or remove the uncertainty

Differentiate longer term risks of adjustment from those relating to the following year

Consider whether sources of uncertainty in previous years remain relevant

Section 4

Clear and specific descriptions of estimates

Disclosures related to estimates should be clear and specific, pinpointing the precise sources of uncertainty and avoiding the use of boilerplate language

34. As with judgements, the review findings suggest an over-reliance on the illustrations in the accounting code guidance notes. For example, most councils followed the illustration in the guidance notes that related to insufficient repairs leading to a reduction in asset lives. However, in many cases, the disclosures were indistinguishable from each other and gave no additional useful information about the council to users.

35. It was not always clear why the areas of estimation uncertainty disclosed were considered to be significantly difficult, subjective or complex, as required by IAS 1. For example, some councils disclosed measuring the fair value of a financial instrument as an estimate, but simply described the process for arriving at fair value without identifying the key sources of uncertainty. Councils did not generally attempt to quantify the uncertainty.

36. It is not necessary to duplicate information between the estimates note and individual notes. More detail can be provided elsewhere in the financial statements provided there is a clear cross-reference in the estimates note; cross-referencing was used by many councils. Exhibit 8 provides an example of cross-referring to more detail:

Exhibit 8

Uncertainty
Estimation of the net liability to pay pensions depends on a number of complex judgements relating to the discount rate used, the rate at which salaries are projected to increase, changes in retirement ages, mortality rates and expected returns on pension fund assets. This is further detailed in Note 18 to the Accounts which includes a table setting out the potential sensitivity of change in assumptions on the Pension Liability. A firm of consulting actuaries is engaged to provide the Council with expert advice about the assumptions to be applied.

Effect if Actual Results Differ from Assumptions
The effects on the net pensions liability of changes in individual assumptions can be measured. For instance, a 0.1% increase in the discount rate assumption would result in a reduction in the pension liability of £16,995,000. However, the assumptions interact in complex ways. During 2019/20, the Council's actuaries advised that the net pension liability had increased by £2,890,000 following an updating of assumptions.

Areas for improvement:

Avoid an over-reliance on the illustrations in the accounting code guidance notes

Explain the sources of uncertainty rather than describe process

Be clear and explain why the areas of estimation uncertainty disclosed were considered to be significantly difficult, subjective or complex

Good practice

Consider the appropriate use of cross referencing

Section 5

Quantification of specific amounts

The specific amounts at risk of material adjustment should be disclosed, rather than just the value of the financial statement line item within which these are contained

37. If the estimation uncertainty identified relates to a particular sub-amount within a line item, users need more than just the line item amount in order to understand the effect. For example, significant uncertainty may attach to just one particular provision within the total provisions balance. However, only around a third of councils consistently quantified the specific amounts at risk of material misstatement.

11 councils consistently disclosed specific amounts

38. Exhibit 9 provides an example of disclosing the specific amounts at risk:

Exhibit 9

Arrears

At 31 March 2020, the authority had Accounts Receivable debtors due of £7.448m, Council Tax debtors of £22.319m and Non Domestic Rate debtors of £3.599m. Provision for bad debts amounted to £1.00m, £10.472m and £3.183m respectively. However, in the current economic climate it is not certain that such an allowance would be sufficient. If collection rates were to deteriorate, an increase in bad debts of 10% would require an additional £0.100m for Accounts Receivable debtors, £1.047m for Council Tax debtors and £0.318m for Non Domestic Rate debtors.

39. It is important to consider the appropriate level to disaggregate an item to ensure the particular uncertainties are explained. For example, councils took different approaches to the impairment of debtors:

- 19 councils disclosed arrears of debtors as an aggregated amount
- 5 councils judged that greater granularity was required and disclosed the impairment of sundry debtors separately from council tax, non-domestic rates and rent arrears

Summary of issues identified and points to consider

Areas for improvement

Disclose the specific amounts at risk of material misstatement

Good practice:

Consider the appropriate level of disaggregation

Section 6

Quantification of assumptions

The assumptions underlying estimates should be quantified when users need this information to fully understand their effect

40. There may be situations where the assumptions underlying the estimates need to be quantified in order for users to be able to understand the positions taken by the council. This is particularly relevant where the matters are likely to be significant sources of estimation uncertainty for a number of councils so stakeholders can make comparisons.

41. Few examples were identified of quantification of the assumptions used. However, three councils quantified discount rates; an example is provided at Exhibit 10:

Exhibit 10

> Council dwellings are valued combining the Beacon Method which aggregates the vacant possession values of each unit of housing stock and the investment approach where the gross rental income is capitalised adopting an appropriate investment yield. The beacon discount factor is determined by comparing the Investment Value to the aggregate value. This methodology takes account of regional variations in capital values, stock condition, rent arrears and voids. The investment yield applied is 8.75%.

42. There is clear scope for councils to consider whether they could enhance stakeholder understanding of the assumptions underlying estimates by providing additional, quantified information.

Good practice

Quantify assumptions so users can understand the positions taken

Provide clear reasons for choosing the numerical assumptions made

Section 7

Sensitivities and range of outcomes

The sensitivity of carrying amounts to assumptions and estimates, and/or the range of reasonably possible outcomes within the next financial year should be disclosed

43. Most councils provided basic sensitivity information for at least some of the estimates disclosed. This was most commonly the case for pensions. Exhibit 11 provides an example:

Exhibit 11

The effects on the net pension's liability of changes in individual assumptions can be measured. The sensitivities regarding the principal assumptions used to measure the scheme liabilities are set out as follows:

Sensitivities at 31 March 2020	Approximate % Increase to Employer Liability	Approximate monetary amount £'000
0.5% decrease in real discount rate	9%	69,825
0.5% increase in salary increase rate	1%	10,530
0.5% increase in pension increase rate	8%	58,338

Disclosures could be improved by indicating the probability of outcomes occurring

44. Other than for pensions, councils appeared to simply follow the indicative percentages or amounts illustrated in the guidance notes rather than considering whether a different metric was a better reflection of the council's local circumstances. For example, where useful economic lives was disclosed, councils used a one year reduction in asset lives but the probability of this occurring was not linked to the assumptions around maintenance spend and impairment.

45. In other cases, councils simply made statements but omitted any amounts. For example, for the impairment of debtors some councils made the statement that a deterioration in collection rates would lead to an increased impairment. The absence of any amounts means it was not possible for a user to assess the impact.

46. Councils did not usually provide information on the range of reasonably possible outcomes. Good disclosures explain where the council's view sits within a range of outcomes, which is valuable for stakeholders and enables them to evaluate the possible effects of estimates in the future.

47. It is helpful to users if the manner in which the estimation uncertainty is expected to be resolved in the future is explained. This might be a particular event, such as the outcome of a court case, a change in circumstances, or new information becoming available. However, few councils disclosed the expected resolution.

48. Some councils disclosed the possibility of future changes in property values and the effect that might have. Future changes in the value of properties that are simply as a result of changes in the market, are not connected to assumptions used in arriving at an estimate at the year end, and should not be disclosed.

Future changes in market value should not be disclosed

49. Where it is impracticable to disclose the extent of the possible effects of an assumption or other source of estimation uncertainty, councils should at least disclose that it is reasonably possible that outcomes within the next financial year that are different from the assumption could require a material adjustment to the carrying amount of the asset or liability affected. One example of a council attempting to highlight this impracticality is set out at Exhibit 12:

Exhibit 12

Property Values	The calculation of the value of certain non-current assets is dependent on their assumed level of occupancy. In addition, it is anticipated that property values will be significantly impacted by the Covid-19 pandemic, however as the market evidence is not currently available, its effect is not reflected in the accounts.	The all-risk yield applied reflects the relative security of the buildings anticipated income stream, any movement in this will have an impact on the valuation.

Areas for improvement

Explain the sensitivity of carrying amounts to changes in assumptions

Disclose the range of possible outcomes

Set out how the uncertainty is expected to be resolved

Good practice

Explain where the council's view sits within a range of outcomes

Where it is impracticable to explain the extent of possible effect, disclose that fact and state that it is reasonably possible that a change in assumptions could require material adjustment

Section 8

Explain changes to past assumptions

Where past assumptions have changed, these changes should be explained if the past uncertainty remains unresolved

50. Where a change in past assumptions amounts to a significant change in an accounting estimate, IAS 8 requires disclosure of the nature and amount of the change. Except for pension liability, it was often not possible to determine from the disclosures whether or not past assumptions had changed.

51. An example of a council providing the disclosure required by IAS 1 for changes in assumptions is provided in Exhibit 13:

Exhibit 13

The effects on the net pension liability of changes in individual assumptions can be measured. For instance, a 0.5% decrease in the discount rate assumption would result in an increase in the pension liability of £147.2m. However, the assumptions interact in complex ways. At 31 March 2020, the Council's actuaries advised that the net pensions liability had increased by £8.1m as a result of estimates being corrected as a result of experience and by £52.0m and £167.1m arising from demographic and financial assumption updates, respectively.

52. Although councils referred to the likely impact of COVID-19 on collection rates for council tax or an increased impairment of debtors, very few councils adjusted the collection or impairment rates they had used in previous years. Those that did, did not generally explain the changes to past assumptions.

Areas for improvement

Provide required disclosures on changes to past assumptions

Section 9

Material valuation uncertainty

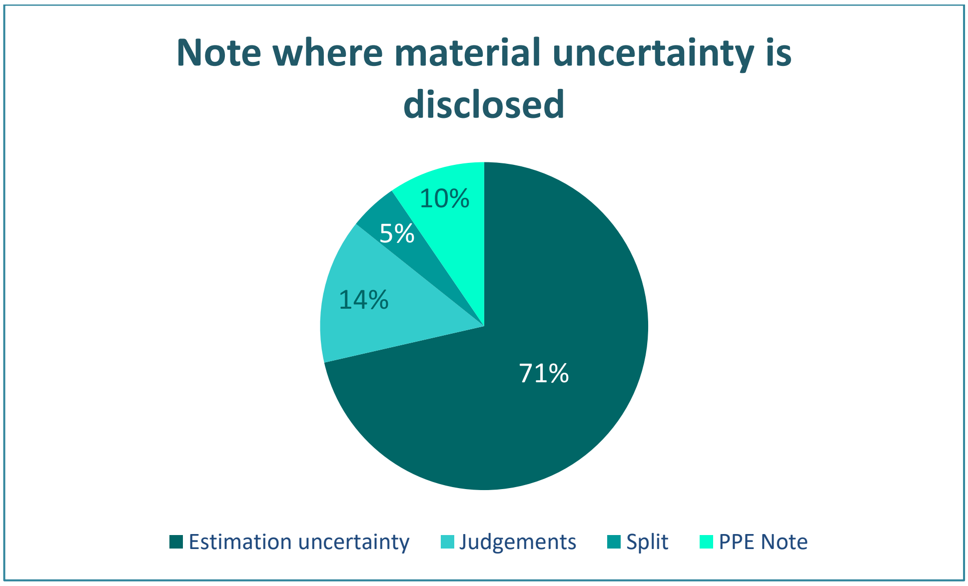
The declaration of a ‘material valuation uncertainty’ should be clearly disclosed in the estimates note

53. An unusual disclosure in the 2019/20 financial statements related to where a valuer had declared a ‘material valuation uncertainty’ in the valuation report. It is expected that such disclosure will also be required in 2020/21.

54. It is reasonable to expect that in order to be transparent, councils would make an explicit statement that such a declaration had been made. 21 councils made a clear and explicit statement in 2019/20. Eight of the other nine councils reviewed made ambiguous references to uncertainty in markets generally but it was not possible for users to determine whether a valuer had declared a ‘material valuation uncertainty’ or, if not, why the disclosure was being made. The ninth council disclosed in the Management Commentary that a ‘material valuation uncertainty’ had been declared but contradicted that by disclosing in a note to the financial statements that the declaration had been withdrawn.

55. Of the 21 councils making the explicit statement, 15 disclosed it in the estimates note. This is appropriate as it relates to an estimation technique rather than the application of an accounting policy. However, the other six disclosed it elsewhere in the financial statements without an appropriate cross-reference (three councils disclosed it in the judgements note, two in the property, plant and equipment note and one council spread it over two notes). This is summarised in Exhibit 14:

Exhibit 14



56. In addition to explicitly stating that the valuer had declared a ‘material valuation uncertainty’, the best disclosures provided a clear explanation of the impact. This included explaining:

- that a ‘material valuation uncertainty’ does not mean that the valuation cannot be relied upon or that there is a misstatement. However, it indicates that less certainty can be attached to the valuation than would otherwise be the case
- that the council has nevertheless judged that the valuation report is sufficiently reliable to be used in measuring property values in the financial statements at 31 March 2020

- the range of uncertainty attached to the different types of asset and potential impact on reported values
- the implications for specialised assets measured on a depreciated replacement cost basis
- the potential future impact on values after 31 March 2020.

57. Exhibit 15 provides an illustration of a council that made these disclosures:

Exhibit 15

Uncertainties	Effect if Actual Results Differ from Assumptions
:In applying the Royal Institution of Chartered Surveyors (RICS) Valuation Global Standards('Red Book'), a material uncertainty has been declared in the valuation report. This is due to market uncertainties caused by Covid-19. The Red Book defines material uncertainty as 'where the degree of uncertainty in a valuation falls outside any parameters that might normally be expected and accepted.' The valuation report has been used to inform the measurement of non-current assets in these financial statements. Although the valuer has declared a material valuation uncertainty, the valuer has continued to exercise professional judgement in preparing the valuation and, therefore, this is the best information available to Council as at 31 March 2020 and can be relied upon.	The valuation report has indicated the range of uncertainty attached to the valuation of the different types of assets including office, retail, industrial and ground leases within the Investment portfolio ranges from 4.8% - 8.15%. Reflecting these movements on the basis of the higher end of the range would provide a 2% change in valuation which is expected to have a £14.15m impact on the Statement of Financial Position. Of the £758,943,050 net book value of land and buildings subject to valuation £461,214,944 relates to specialised assets valued on a depreciated replacement cost basis. Here the valuer bases their assessment on the cost to the Council of replacing the service potential of the assets; the uncertainty relates to the estimated costs of, rather than
	the extent of, service potential to be replaced. Covid-19 may also have a further impact of the value of assets subsequent to the balance sheet date. There is to date, limited market evidence to indicate the impact on particular categories of non-current asset.

Areas for improvement

Disclose a 'material valuation uncertainty' in the estimates note

Good practice

Provide a clear explanation of the impact

Appendix 1

Tips on selecting and disclosing judgements

Key question	Consideration
Which accounting policy is affected by the judgement?	Consider the accounting policies to determine which ones require significant judgement in their application. If a specific policy cannot be identified, it is likely that disclosure as a judgement is not appropriate.
Does the judgement impact on the classification or recognition of an item in the financial statements?	Consider the nature of the impact on the financial statements. It is likely that disclosure as a judgement is not appropriate where it: • does not affect the classification or recognition of the item • relates to an estimation technique rather than an accounting policy (it may however require to be disclosed separately as an estimate).
What effect does the judgement have on amounts recognised in the financial statements?	Consider the materiality of the effect of the judgement on the financial statements. The language used in the accounting code makes it clear that not all judgements should be disclosed: • Disclose the judgement if it has a material effect on the reported amounts. • If the effect is not material, disclosure is not appropriate.
Does the disclosure of the judgement: • Explain the basis of the judgement • Set out the factors taken into account • Refer to relevant technical sources • Justify the view taken ahead of any potential alternatives?	The note should explain the judgement made and provide justification for the view taken. The aim is to highlight significant areas of the financial statements where others could reasonably have applied the accounting policy in a different way. It may be helpful to provide basic information that would allow an assessment of the impact of an alternative treatment.

Appendix 2

Tips on selecting and disclosing estimates

Key question	Consideration
What are the main uncertain future events that affect estimates in the financial statements?	Estimates are necessary where there is incomplete or imperfect information which will only be enhanced as a result of future events.
What assumptions are made about the uncertain future events?	Consider the assumptions being made to compensate for information that is incomplete at the time the financial statements are authorised for issue.
Is there a significant risk of a material adjustment to the estimate within the next 12 months?	Re-estimation is required as the outcomes of the future events become known, and this may lead to an adjustment to the estimate. These criteria will exclude the majority of estimates that a body might make as they require that: • an adjustment arising from re-estimation must itself potentially be material (rather than simply relate to a material balance) • the risk of adjustment must be significant (i.e. higher than routine) • the re-estimation will take place before the end of the next financial year. Disclosures will therefore be restricted to assets and liabilities whose carrying amount is dependent on estimates that are in turn dependent on difficult, subjective or complex judgements for which there is a risk that re-estimation with material effect in the next year might be required.
Does the disclosure of the estimate provide details of the: • nature of the relevant estimated assets and liabilities • their carrying amounts • the nature of the assumption or other estimation uncertainty • the sensitivity of carrying amounts to the assumptions, including the reasons for the sensitivity; • the expected resolution of the uncertainty and the range of reasonably possible outcomes within the next financial year • an explanation of changes made to past assumptions?	The disclosures should help users to understand the judgements that management makes about the future and about other sources of estimation uncertainty. The nature and extent of the information provided vary according to the nature of the assumption and other circumstances. If it is impracticable to disclose the range of possible outcomes, disclose that it is reasonably possible that outcomes within the next financial year that are different from the assumption could require a material adjustment.

Appendix 3

Analysis of impairment of debtors disclosure

Good practice	Review finding
Was there a significant risk of a material adjustment to the carrying amount of debtors?	While debtors was a material balance, it was not always the case that the adjustment would be material.
Was boiler-plate language avoided?	Councils generally lifted the illustrative wording for rates arrears from the accounting code guidance notes, though sometimes omitting the sensitivity analysis aspect.
Were the specific amounts at risk disclosed?	Most councils disclosed the impairment of debtors as a single item, while a few disclosed the impairment of sundry debtors, council tax and non-domestic rates separately.
Were the underlying assumptions quantified?	The underlying assumptions were not generally quantified.
Was sensitivity to changes in assumptions and/or the range of expected outcomes disclosed?	Councils often explained the effect of a deterioration in collection rates (i.e. it would lead to an increase in impairment) but they did not tend to provide any sensitivity or range of outcome information.
Were changes to past assumptions explained?	Despite the likely impact of COVID-19 on collection rates for council tax or an increased impairment of debtors, few councils adjusted the collection or impairment rates they used in previous years. Those that did, did not generally explain changes to past assumptions.

Good Practice Note: Judgements and estimates

If you require this publication in an alternative format and/or language, please contact us to discuss your needs: 0131 625 1500 or **info@audit-scotland.gov.uk**

For the latest news, reports and updates, follow us on:

Audit Scotland, 4th Floor, 102 West Port, Edinburgh, EH3 9DN
T: 0131 625 1500